The Economy

After growing briskly in 2004, output of the national economy grew at a slower pace in the first quarter of 2005. Consumer spending rose only moderately as consumers spent less on motor vehicles and parts. A jump in imports and a smaller gain in purchases of equipment and software by businesses also contributed to the slowdown in economic growth. Increased inventory accumulation by businesses and a pickup in export growth limited the slowdown. Monthly job gains were somewhat smaller, on average, in the first quarter of 2005 than in 2004 as a whole. But a big job gain in April pushed the 2005 average above last year's average gain. Housing markets and residential construction continued to be robust in the first quarter, when the weather cooperated, but manufacturing lost some steam. Higher energy prices, a modest increase in interest rates, and a lack of fiscal stimulus were expected to slow economic growth in 2005, but the onset of this slowing was stronger than expected. As a result, the major stock market indexes lost ground and consumers became less confident in the first four months of the year. The Federal Reserve has tightened monetary policy throughout this year, demonstrating that it is not overly concerned by the slowdown in economic growth in the first quarter.

California's economy continued to generate new jobs in the first quarter of 2005, and the state's unemployment rate fell considerably. Total housing permits granted were down slightly from a year earlier. But existing home sales remained brisk, and the value of nonresidential permits increased. The state's tourism industry continued to improve, as evidenced by increased airport passenger counts and higher hotel/motel occupancy rates. Personal income picked up solidly in the fourth quarter of 2004. Exports of made-in-California merchandise and port data on exports and imports remained strong in the first two months of 2005. Signs of improvement were seen in the San Francisco Bay Area economy, but that economy is far from recovered.

The expansions of the national and California economies decelerated somewhat in the first quarter of 2005, in part due to surging oil prices. Given the big gains in jobs and light vehicle sales in the nation in April, this slowdown may well turn out to be nothing more than a "soft patch" like the one in the second quarter of 2004. Nevertheless, the risks to the outlook have increased in the last four months.

The Nation

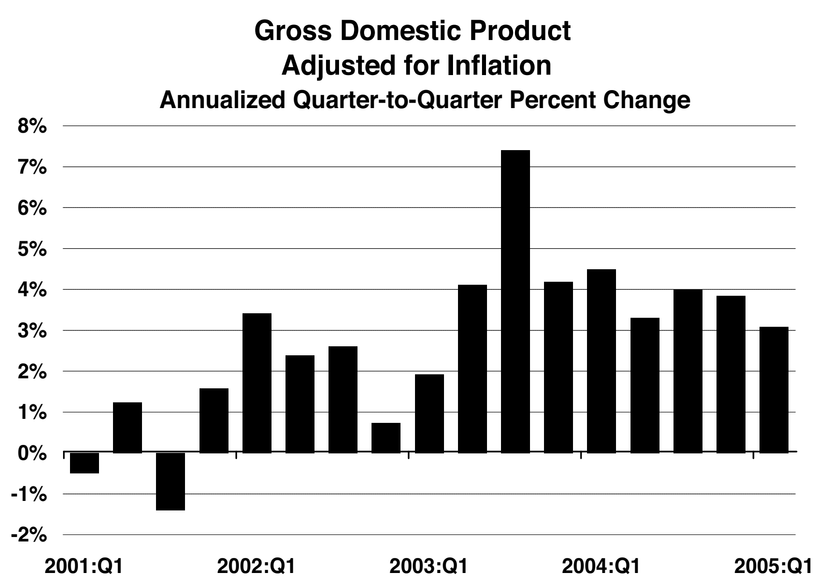
The U.S. Commerce Department's first estimate of the growth of inflation-adjusted gross domestic product (GDP) in the first quarter of 2005 was an annualized 3.1 percent, down from the 3.8 percent growth in the fourth quarter of 2004 (Figure ECO-01). Slower growth in consumer spending played a significant role in the decline in real GDP growth. In particular, the value of consumers' purchases of durable goods was unchanged from the fourth quarter of 2004, as higher oil prices, less favorable incentive programs, and poor weather in January depressed light vehicle purchases. Light vehicle sales bounced back in April, however, suggesting that higher gasoline prices have not prevented consumers from buying new vehicles. Consumers are concerned, however. Consumer sentiment fell in each of the first four months of the year.

Slower growth in spending by businesses on equipment and software was also instrumental in the decline in real GDP growth. Investment in transportation equipment and industrial equipment was particularly weak. Purchases of new information-processing equipment and software, on the other hand, were very strong. Residential construction made a small contribution to real GDP growth, and nonresidential construction, a slight subtraction. Inventory investment made a big contribution to real GDP growth. Nondefense capital goods orders fell sharply in March—an indication that capital spending may fall in the coming months. In addition, three consecutive months of declining total nondurable goods orders and five consecutive months of declines in the Institute for Supply Management's composite manufacturing index reflect a manufacturing sector that is not growing nearly as quickly as it was in the first half of 2004.

Net exports (exports minus imports) fell for the sixth consecutive quarter in the first quarter of 2005. However, the more recent report on the trade deficit in March showed an unexpected decline, meaning first-quarter net exports did not fall as much as initially estimated. As a result, the U.S. Commerce Department will increase net exports when they revise their estimate of first-quarter real GDP in late May.

Nonfarm payroll employment increased for the twenty-third consecutive month in April. Gains in the first three months of this year were somewhat smaller than those in the fourth quarter of 2004, but the large April gain pulled the average monthly gain for 2005 above the average gain for all of 2004. Job gains continue to be widespread across major industry sectors. The national unemployment rate has trended downward for almost two years and was 5.2 percent in April.

Figure ECO-01



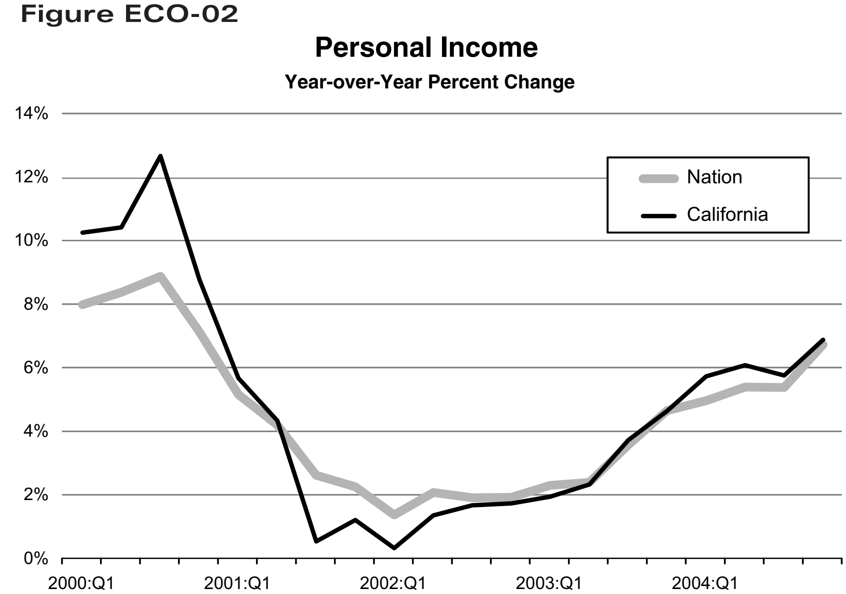
Housing markets remained strong in the first quarter of the year, although re-sales were not quite as strong as they were in the fourth quarter of 2004. New home sales reached a record high in March, on a seasonally-adjusted basis.

Higher inflation has become a risk to the outlook. Sharply higher oil prices have driven up general inflation measures considerably in the last year. But a greater concern is that other prices are also increasing. For example, the Consumer Price index that strips away food and energy prices—the so-called core CPI—was 2.3 percent higher in March than a year earlier. This measure reached its cyclical low of 1.1 percent in November 2003 and has trended upward ever since. Core inflation is still quite low compared to historical averages, but the Federal Reserve is clearly concerned about the upward trend of the last year and a half. The central bank's interest rate committee has raised its target for the federal funds rate by one-quarter percentage point in each of its last eight meetings. And it is widely expected to continue bumping up its target interest rate at its remaining meetings this year. This tightening of monetary policy has not yet had much effect on long-term interest rates, but it likely will in time. Then, interest rate-sensitive spending, like home and durable goods purchases, will begin to slow, restraining growth in the economy.

California

Statistics released since January put in sharper focus the significant improvement in the California economy during 2004. The annual benchmark revision of employment statistics revealed that more jobs were created in the state during the year than initially thought. In addition, taxable sales estimates have been revised upward. And the first estimate of fourth-quarter personal income was strong, cementing the view that personal income growth picked up considerably in 2004. As recently as the second half of 2003, personal income was growing at a 4.1 percent year-over-year pace. By the second half of 2004, the pace had accelerated to a 6.3 percent pace, although about one half of a percentage point of the more recent pace was due to an unprecedented dividend payment. In addition, California's personal income growth has outstripped the nation's as a whole since the fourth quarter of 2003 (Figure ECO-02).

Figure ECO-02



Made-in-California exports expanded substantially in 2004, reaching their highest level since 2000. Building on solid growth in the final months of 2003, exports surged by 17 percent during 2004. High-tech exports expanded by more than 15 percent, and exports of both nonelectrical machinery and transportation equipment grew by more than 30 percent. State exports expanded to all major markets, led by sharp gains in shipments to Mexico, Japan, Mainland China, South Korea, Taiwan, Canada, Singapore, and the United Kingdom. California deliveries to Mainland China grew by over 25 percent in 2004, the fastest pace among the state's major trading partners.

California's residential real estate markets made impressive gains in 2004, but cooled somewhat during the first quarter of 2005. Buoyed by job market gains, improved personal income gains, and low mortgage rates, home sales were robust throughout 2004, and the median single-family home price appreciated by over 21 percent from 2003. While real estate markets remained vigorous in early 2005, sales and price gains are not likely to be as big in 2005 as in 2004. During the first three months of 2005, both the inventory of homes for sale and the time it took to sell a home rose substantially from a year earlier.

A much welcomed development in 2004 was the renewal of employment growth. Over 250,000 new nonfarm payroll jobs were created during 2004, the first good gain since 2000. (The average level of nonfarm payroll employment was 147,000 higher in 2004 than in 2003.) On a percentage basis, job gains were highest in the San Joaquin Valley. Southern California was a close second. The San Francisco Bay Area trailed considerably but has posted year-over-year job gains since July 2004.

The Forecast

Higher energy prices, somewhat higher interest rates, and a lack of fiscal stimulus are expected to slow economic growth in 2005. In fact, growth in consumer spending slowed in the first quarter, largely because of weak light vehicle sales in January. Light vehicle sales have since bounced back, with April bringing a good increase. In addition, inflation-adjusted disposable income continues to grow at a good clip that is supportive of consumer spending. Consumer confidence remains above average levels of past expansions even after falling in the first four months of the year. There is no denying, however, that consumers' debt loads are high and that a sharp increase in interest rates would put a good number of consumers in a bind. But sharply higher interest rates are not expected. In fact, after eight tightening steps by the Federal Reserve, long-term interest rates are slightly lower. But the best news for consumer spending was the large increase in nonfarm payrolls in the nation in April. On balance, the fundamentals for consumer spending remain quite good.

For 2005 as a whole, real U.S. GDP will grow by 3.6 percent, down from 4.4 percent in 2004, but still sufficient to allow for improved job growth (Figure ECO-03). Output growth will slow further in 2006, to 3.0 percent, as consumer spending and business investment grow less quickly. Corporate profits will be strong in 2005 before declining slightly in 2006.

On an annual average basis, job growth will improve to 1.7 percent in California in 2005 and 2006 (Figure ECO-04). Unemployment was 5.8 percent in January and February and 5.4 percent in March, and is not expected to change much during the rest of 2005 and in 2006. Growth in total state personal income will dip slightly in 2005 before edging up in 2006. Housing permits will trend downward.

Figure ECO-03

Selected U.S. Economic Indicators

	2004 (Est.)	2005 (Projected)	2006 (Projected)
Real gross domestic product, (2000 dollar) (Percent change)	4.4	3.6	3.0
Personal consumption expenditures	3.8	3.3	2.7
Gross private domestic investment	13.2	6.7	2.6
Government purchases of goods and services	1.9	2.3	2.0
GDP deflator (2000=100) (Percent change)	2.2	2.4	2.2
GDP, (Current dollar) (Percent change)	6.6	6.1	5.2
Federal funds rate (Percent)	1.4	3.2	4.2
Personal income (Percent change)	5.6	5.6	5.9
Corporate profits before taxes (Percent change)	12.7	41.9	(3.6)
Nonfarm wage and salary employment (Millions)	131.5	133.6	135.4
(Percent change)	1.1	1.6	1.4
Unemployment rate (Percent)	5.5	5.2	5.2
Housing starts (Millions)	2.0	1.9	1.8
(Percent change)	5.4	(2.5)	(7.1)
New car and light truck sales (Millions)	16.8	16.6	16.9
(Percent change)	0.9	(0.9)	1.4
Consumer price index (1982-84=100)	188.9	193.7	198.0
(Percent change)	2.7	2.6	2.2

Forecast based on data available as of April 2005.
Percent changes calculated from unrounded data.

Figure ECO-04

Selected California Economic Indicators

			Projected			
	2004	Percent change	2005	Percent change	2006	Percent change
Personal income ($ billions)	1,257.0	6.1%	1,329.0	5.7%	1,406.5	5.8%
Nonfarm W&S employment (thousands)	14,537.2	1.0%	14,789.9	1.7%	15,048.6	1.7%
Natural resources and mining	22.6	1.5%	23.0	1.8%	23.9	4.3%
Construction	849.1	6.7%	886.0	4.3%	908.1	2.5%
Manufacturing	1,531.0	-1.1%	1,544.8	0.9%	1,562.8	1.2%
High technology	396.4	-0.9%	402.7	1.6%	409.3	1.6%
Trade, transportation, & utilities	2,751.4	1.2%	2,800.1	1.8%	2,841.6	1.5%
Information	484.0	1.6%	489.2	1.1%	500.6	2.3%
High technology	208.8	-3.2%	210.7	0.9%	214.9	2.0%
Financial activities	900.6	1.7%	915.1	1.6%	923.6	0.9%
Professional and business services	2,099.5	0.9%	2,170.7	3.4%	2,225.3	2.5%
High technology	261.0	-0.5%	269.1	3.1%	277.4	3.1%
Educational and health services	1,562.0	1.7%	1,593.3	2.0%	1,632.3	2.4%
Leisure and hospitality	1,442.1	3.0%	1,477.7	2.5%	1,508.6	2.1%
Other services	504.6	0.0%	511.8	1.4%	520.1	1.6%
Government	2,390.4	-1.4%	2,378.4	-0.5%	2,401.6	1.0%
Unemployment rate	6.2%		5.7%		5.7%	
Housing permits (thousands of units)	213	7.6%	190	-10.5%	186	-2.1%
Consumer price index (1982-84=100)	195.3	2.6%	200.9	2.9%	205.7	2.4%

Forecast based on data available as of April 2005.
Percent changes calculated from unrounded data.